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IN THE

Supreme Court of the United States

OCTOBER TERM, 1982

UNITED STATES OF AMERICA,
Petitioner,

v.

ARTHUR YOUNG AND COMPANY, *et al.*,
Respondents.

On Writ of Certiorari to the
United States Court of Appeals for the Second Circuit

BRIEF AMICUS CURIAE OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

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IN THE

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OCTOBER TERM, 1982

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UNITED STATES OF AMERICA,
Petitioner,

v.

ARTHUR YOUNG AND COMPANY, *et al.*,
Respondents.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

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BRIEF AMICUS CURIAE OF THE CHAMBER OF COMMERCE OF THE UNITED STATES

INTEREST OF THE AMICUS CURIAE [1]

The Chamber is the largest federation of corporations, trade associations, chambers of commerce and individuals engaged in business and the professions, with an aggregate membership in excess of 209,000.

The Chamber regularly presents its member's views to this Court and the lower federal courts on matters of major concern to the business community.[2] Of particular

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[1] This brief is filed with the written consent of the parties pursuant to Supreme Court Rule 36.1. The Chamber is submitting Petitioner's consent to the clerk. Respondents are sending their consent directly to the Court.

[2] *See Newport News Shipbuilding and Drydock Co.* v. *EEOC*, —— U.S. ——, No. 82-411 (June 20, 1983); *Upjohn Co.* v. *United States*, 449 U.S. 383 (1981); *First National Maintenance Corp.* v. *NLRB*, 449 U.S. 1076 (1981); *Gould Corp.* v. *NLRB*, 612 F.2d 728 (3rd Cir. 1979).

importance here is the Chamber's participation as an *amicus curiae* in support of the *Petition for Certiorari* in *El Paso Company* v. *United States, petition for cert. filed*, 51 U.S.L.W. 3342, (U.S. Oct. 22, 1982) (No. 82-716).

The ultimate issue presented in *El Paso* is identical to that presented here: absent allegations of fraud, can the Internal Revenue Service ("I.R.S.") obtain enforcement of a summons for tax analysis workpapers prepared by an independent, certified public accountant for a publicly-held corporation?

This issue is of importance to a substantial number of the Chamber's publicly-held corporate members. It also concerns the Chamber's non-public members, since the I.R.S. actions in this case raise the spectre that it may well take the same position with the non-public members of the business community.

The tax analysis (or accrual) workpapers contain a corporation's "worst case" estimate of its contingent tax liability based on the issues it thinks might be raised in an audit of its tax returns, and its speculation concerning the ultimate resolution of those issues. As such, they constitute a road map to a corporation's negotiating and settlement positions on issues discussed therein.

The concern of the Chamber's members is heightened by the fact that preparation of the tax accrual workpapers is not a discretionary matter for publicly held corporations. To the contrary, the Securities and Exchange Commission ("SEC") requires publicly held corporations to file periodically audited financial statements. SEC regulations,[3] and the standards of the accounting profession[4] require that these financial statements disclose "material contingent liabilities." The possibility of additional

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[3] Regulation S-X, 17 C.F.R. 210.1-02(n) (1981).

[4] American Institute of Certified Public Accountants, Statement on Auditing Standards No. 1, 110.01 (1973); *Financial Accounting* Standards Board, Statement of Financial Accounting Standards No. 5 (1975).

tax liability is normally considered to be a material contingent liability.

The Chamber is concerned that if the Internal Revenue Service's position is adopted, it will substantially interfere with the ability of management of publicly held corporations to have full and frank discussions with their independent auditors. Such a result would not only be a detriment to the publicly held members of the Chamber, but to the substantial number of the Chamber's members who rely on complete financial reporting in order to invest in publicly held corporations.

SUMMARY OF ARGUMENT

Tax accrual workpapers are a corporation's estimate of its tax liability for a particular year after all tax audits, negotiations, and litigation of contested areas are completed. The workpapers are not used in any way to assist in preparation of the corporate tax return, but rather are created independently of the preparation of the return.

In large part, these workpapers are created to comply with Securities and Exchange Commission Regulations designed to insure that investors receive accurate data on the financial conditions of public corporations.[6] The Securities Exchange Act of 1934, 15 U.S.C. § 78a *et seq.*, requires publicly held corporations to file financial statements, which have been verified by independent auditors "in accordance with generally accepted auditing standards".[6] To assure that the corporation's balance sheet does not present "an overly-rosy view of a corporation's financial health, [those standards require that] the balance sheet must provide for contingent future tax liabilities." [7]

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[5] *See* Regulation 2-X, 17 C.F.R. 210.1-02(n) (1981).

[6] 17 C.F.R. § 210.1-02(d).

[7] *United States* v. *El Paso Co.*, 682 F.2d 530, 534 (5th Cir. 1981), *Petition for Cert. filed*, 51 U.S.L.W. 3342 (U.S. Oct. 22, 1982) (No. 82-716).

In essence, the corporation sets aside these amounts to cover additional taxes that it may be liable for should the I.R.S. question the company's return.[8]

In performing the audit function, including the preparation of the tax analsyis workpapers, an "auditor acquires an intimate knowledge of the client's most private business secrets and confidences." [9]

"The accountant's evaluation of the tax contingency figure is based on an analysis of the client's records and an assessment of opinions, speculations, and projections made by the client's personnel and legal counsel regarding unclear or aggressive tax positions. The independent accountant explores tax effects with corporate officials, often on a hypothetical worst-case basis, to ensure that the tax accrual figure accurately reflects the full extent of the client's exposure to additional tax liability." (Footnotes omitted) Caplin, *Government Access to Independent Accountants' Tax Accrual Workpapers*, 1 Va. Tax Review 59-60 (Spring, 1981)

Disclosure of the workpapers will inevitably result in disclosure of these confidences, thereby inhibiting full and frank communications between corporations and their accountants. Therefore, there is a basic tension between the policies underlying the federal securities laws and the I.R.S.'s attempts to obtain the documents at issue here.

As the court below found, that tension should be resolved by denying the I.R.S. the documents they seek here. The documents were not used to prepare the returns in question and are not necessary for the I.R.S. to assess the correctness of the returns.

Even if the significant conflict between the securities laws and the I.R.S. attempts to obtain these documents is

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[8] *Id.*

[9] Note, *Government Access to Corporate Documents and Auditor's Workpapers: Shall We Include Auditors Among the Privileged Few?*, Winter 1977. J. Corp. L. 353.

put aside, the I.R.S. should be denied access to the documents on the basis that absent allegations of fraud, they are not relevant to an I.R.S. investigation. *United States* v. *Coopers and Lybrand*, 550 F.2d 615 (10th Cir. 1977).

As noted above, the workpapers are prepared independently of the tax return, and are not a factual source for preparation of the return. The Government's contention that anything that "might throw light" on the correctness of the return is relevant is no standard at all, since anything even tangentially related to the subject of taxes would meet the standard. Such a standard provides little protection to businesses from I.R.S. overzealousness.

ARGUMENT

I. THE POLICIES UNDERLYING THE FEDERAL SECURITIES LAWS JUSTIFY ACCORDING INDEPENDENT AUDITOR'S TAX ANALYSIS WORKPAPERS A QUALIFIED WORK-PRODUCT PRIVILEGE.

The policy underlying our federal securities laws is that all investors in publicly held corporations should be entitled to the most complete financial information possible.[10] Any government action which impedes this policy must be seriously questioned. The I.R.S. attempts to obtain tax analysis workpapers is precisely such governmental action. It is for this reason that the court below found a qualified privilege for tax analysis workpapers. *U.S.* v. *Arthur Young and Co.*, 677 F.2d 211, 220 (2d Cir. 1982).

In preparing tax analysis workpapers, the independent auditor "explores tax effects with corporate officials, often

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[10] The Chamber is a strong advocate of this policy. Its policy manual states: "it is essential that legislation which assures investors of the availability of adequate information regarding proposed issues of securities continue in force." *Policy Declarations Adopted by the Chamber of Commerce of the U.S.*, pp. 183-184 (1981).

on a hypothetical worst-case basis." Caplin, *supra* at 60. Of particular significance is the fact that the workpapers "pinpoint issues of concern to the taxpapers and present careful estimates of the likelihood that the Service will prevail in the case of controversy." *Id.* As the Second Circuit observed in this case: [11]

> "The inquiry necessarily lays bare not only the auditor's thoughts but also the taxpayer's basic thinking, including decisions not to litigate that are based on considerations wholly apart from the inherent legality of what the taxpayer has done, e.g., the cost of litigation and the possibility that confidential information may be disclosed to competitors.

Id. at 220.

Obviously, one of the primary incentives for a corporate client to engage in such a soul-baring exchange is the auditors' ethical obligation not to disclose information obtained in the course of an audit.[12] However, if corporate officials realize that this information will be obtained by the I.R.S. through access to the auditor's tax analysis workpapers, they may well be less than candid with the independent auditors. *United States v. Arthur Young and Co.*, 677 F.2d at 220.

This sensitivity was articulated by a past president of the American Institute of Certified Public Accountants in *United States* v. *Coopers and Lybrand*:

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[11] One commentator has observed that, "[t]he relationship between a corporation and its auditor is essentially confidential. In the course of an audit examination, the auditor acquires an intimate knowledge of the client's most private business secrets and confidences." (footnotes omitted) Note: *Government Access to Corporate Documents and Auditors' Workpapers: Shall We Include Auditors Among the Privileged Few?*, *supra* at 353.

[12] American Institute of Certified Public Accountants, Code of Professional Ethics Rule 301 provides: "A member shall not disclose any confidential information obtained in the course of a professional engagement except with the consent of the client."

> . . . I would not presume to suggest, Your Honor, that a taxpayer, be it a large corporation or a small one, be empowered in any way to withhold the facts on which they have based their income tax return or the basis on which they have computed their tax. This certainly is part and parcel of our system of self assessment, and were we to eliminate that, the Government would be terribly hampered, but what I'm concerned about is this ability of the Government to look into the client's mind to determine not what the facts are on which the tax is based, but what the worst possible nightmare is the client can conceive can happen if every assumption on which he based his tax were to go against him in some kind of litigation.
>
> He may think up contingencies even more lurid than the worst contingencies a revenue agent comes up with, and with that information available to the revenue agent just for the asking, I think eventually destroy the system of auditing that we have established because it would eliminate the freedom that the client feels of being able to muse with us about, well, what if this capital gains is treated as an ordinary income? What are the potentials? What are the chances? Well, the chances are 60-40 or 90-10, one way or the other.
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> • • •
>
> If we were hampered in any audit situation by the fact that the client knows that if he gives us any data about that its going to be readily available to Government, I cannot imagine how we would be able to render audit opinions for that client for very long. It would just absolutely cut off our communication . . .

413 F. Supp. 942 at 953-954 (D. Colo. 1975), *aff'd.*, 550 F.2d 615 (10th Cir. 1977)

The Chamber is greatly concerned about the ramifications of such a "cut off" in communications. The ability of investors to obtain complete and accurate financial

data is crucial to our economic system. If a "prudent organization might not be perfectly candid with [its] independent auditors," [13] investors are likely to suffer. Moreover, as discussed *infra* at 11-12, the I.R.S. attempts to obtain tax analysis workpapers will adversely impact our system of taxation which heavily relies on voluntary compliance and self-assessment.

Accordingly, the Chamber urges the Court to affirm the Second Circuit's application of *Hickman* v. *Taylor*, 329 U.S. 495 (1947), to the situation presented here, by establishing a qualified work-product privilege for tax accrual workpapers.

The need of the I.R.S. for the information must be balanced against the strong public policies in favor of maximum disclosure to independent auditors.

II. TAX ANALYSIS WORKPAPERS SHOULD NOT BE CONSIDERED RELEVANT PURSUANT TO I.R.C. SECTION 7602, ABSENT AN ALLEGATION OF FRAUD OR A SHOWING OF COMPELLING NEED.

Although the Second Circuit found tax analysis workpapers to be protected from disclosure by a qualified work-product privilege, it rejected Arthur Young's contention that such workpapers are not relevant under I.R.C. section 7602. The Chamber believes the Second Circuit erred in this regard, and urges this Court to reverse that holding.

In *United States* v. *Powell*, 379 U.S. 48 (1964), this Court articulated four requirements that must be present for the I.R.S. to obtain enforcement of a section 7602 summons:

> [The I.R.S.] must show that the investigation will be conducted pursuant to a legitimate purpose, that the inquiry may be relevant to the purpose, that the information sought is not already within the Com-

[13] *United States* v. *Arthur Young and Co.*, 677 F.2d at 220.

> missioner's possession, and that the administrative steps required by the Code have been followed.

379 U.S. at 57-58.

It has also been said that *Powell* established a fifth requirement, that the I.R.S. use its summons authority in good faith, Caplin, *supra*, at 63.

The primary question presented is whether tax analysis workpapers are relevant to an I.R.S. investigation absent an allegation of fraud, or a showing of compelling need. In holding that tax analysis workpapers are relevant, the Second Circuit expressly disagreed with the holding of the Tenth Circuit in *Coopers and Lybrand*, and the related holding of the Eighth Circuit in *United States* v. *Matras*, 487 F.2d 1271 (1973). The test of relevance used by the Second Circuit was whether the requested documents "might have thrown light upon the correctness of the return." *United States* v. *Arthur Young*, 677 F.2d at 218.

The Chamber believes the Second Circuit's litmus test is far too broad, encompassing almost anything the I.R.S. wishes to obtain. In this regard, the Tenth Circuit in *Coopers and Lybrand*, quoting from an opinion of the Eighth Circuit, stated:

> "If we were to acceed to the government's view, it is difficult to imagine corporate materials that might not contribute to a more comprehensive understanding of the workings of the corporation, and thus, according to the government, be deemed relevant to the tax investigation."

550 F.2d at 621, *quoting*, *U.S.* v. *Matras*, 487 F.2d at 1274-1275.[14]

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[14] Interestingly, the Eighth Circuit in *Matras* began its inquiry as to whether the documents sought were relevant, with the same test used by the Second Circuit here: whether the sought after documents "might have thrown light upon the correctness of the taxpayer's return." 487 F.2d at 1274. Whether "light is thrown must

In preparing a tax pool analysis,

> . . . the auditors and corporate management engage in a worst-case analysis of the tax treatment of selected items on the corporation's return. A worst case tax assessment is then computed and a portion of this amount is accrued or reserved. This process takes place separately from the preparation of the actual tax return, regardless of whether the corporation also has engaged the auditing firm to prepare the corporation's tax return. (footnotes omitted)

Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 Wash. U.L.Q. 185 (1982)

Precisely because preparation of this analysis is done independently of preparation of the corporation's tax return, and is in no way a factual predicate for the company's tax return, the analysis should not be considered relevant to an I.R.S. investigation.[15] *U.S.* v. *Coopers & Lybrand*, 550 F.2d at 618-621.

The Chamber believes that former I.R.S. Commissioner Caplin's view of the law is far more reasonable than

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be a realistic expectation, rather than an idle hope." *Id.* The Court then went on to say:

> Certainly, a taxpayer should not erect roadblocks for the purpose of frustrating or preventing the I.R.S. from a full scale inquiry of the liability of the taxpayer. By the same token, the government should not for the mere sake of its convenience, impose unnecessary burdens on a taxpayer in conducting an audit or investigation for tax liability, particularly, where, as here, there is no indication of a purpose to escape any tax liability. The term "relevant" connotes and encompasses more than "convenience."

Id. at 1274-1275; *Quoted with approval in, U.S.* v. *Coopers & Lybrand*, 550 F.2d at 620-621.

[15] An allegation of fraud by the Service may well lead to a different conclusion as to the relevance of the analysis. But no allegation of fraud has been made here, and that question can therefore be left for another case.

that asserted by the Service here. Caplin states that the "quantum of proof necessary to show relevance" is not static, but varies according to the circumstances. Caplin, *supra* at 65. In each case, the touchstone is reasonableness. *Id.* Where, as here, the documents contain no factual material used to prepare the return, the materials are sought from third parties such as Arthur Young,[16] and the documents were created for purposes other than compliance with the Internal Revenue Code, a far greater showing of relevance is necessary. *Id.* at 65-68.

Under circumstances such as these, the I.R.S. burden should be a heavy one. That burden cannot be met solely by the government's need for a "road map." *United States* v. *Matras*, 487 F.2d at 275. *Accord*, *United States* v. *Coopers & Lybrand*, 550 F.2d at 621.

As we noted previously, inherent in the determination of whether a section 7602 summons should be enforced is whether the I.R.S. position is reasonable. *See supra* p. 9. The Chamber believes I.R.S. attempts to obtain tax analysis workpapers violate concepts of fundamental fairness, and therefore are unreasonable. As one commentator has noted:

> A corporation has a legal right to decrease its taxes by means that it determines are in conformance with the law. Requiring disclosure of the arguments the taxpayer conjures up against this position is untenable. The self assessment system is buttressed by the broad investigatory powers of the I.R.S., but it is also grounded in an assumption of fair play by both sides. A requirement that the taxpayer, in effect, prepare the I.R.S.'s case against his position is beyond the bounds of fair play and is thus disruptive to the self assessment system. (footnotes omitted)

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[16] *United States* v. *Harrington*, 388 F.2d 520, 523 (2d Cir. 1968); *United States* v. *Theodore*, 479 F.2d 749, 754 (4th Cir. 1973); *United States* v. *Coopers and Lybrand*, 550 F.2d at 621.

Note, *A Balancing Approach to the Discoverability of Accountants' Tax Liability Workpapers Under Section 7602 of the Internal Revenue Code*, 60 Wash. U.L.Q. *supra* at 207).[17]

Justice Jackson statement in his concurring opinion in *Hickman* v. *Taylor*, 329 U.S. at 516, is applicable here: "Discovery was hardly intended to enable a learned profession to perform its functions . . . on wits borrowed from its adversary."[18]

CONCLUSION

For the foregoing reasons, the Chamber of Commerce of the United States respectfully urges this Court to affirm the holding of the U.S. Court of Appeals for the Second Circuit that tax analysis workpapers are subject to a work-product privilege, and reverse the holding of that court that those workpapers are relevant to an I.R.S. investigation where there has been no allegation of fraud.

Respectfully submitted,

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[17] Similarly, former Commissioner Caplin states: "The federal income tax system is based upon cooperation by the public through voluntary compliance and self-assessment of taxes to preserve this process the *Service* must treat taxpayers in a fair, even-handed manner, and demonstrate to the public that it is doing so." Caplin, *supra* at 82.

[18] Quoted in *Upjohn Co.* v. *United States*, 449 U.S. 383 at 396 (1981).